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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1970

No. 1442

CLEMENT A. EVANS & COMPANY, INC.,
Petitioner,

vs.

A. M. KIDDER & COMPANY, INC., EDWARD M. GARRETT and WILLIAM J. McALPIN, JR.,
Respondents.

PETITION FOR A WRIT OF CERTIORARI

To the United States Court of Appeals
For the Fifth Circuit

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St. Louis Law Printing Co., Inc., 411-15 N. Eighth St. 63101 314-231-4477

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PETITION FOR A WRIT OF CERTIORARI

To the United States Court of Appeals
For the Fifth Circuit

Petitioner, Clement A. Evans & Company, Inc., prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fifth Circuit entered in the above-entitled case on November 5, 1970.

OPINION BELOW

The opinion and judgment rendered by the United States Court of Appeals for the Fifth Circuit on November 5, 1970, is reported at 434 F. 2d 100 (5th Cir. 1970). A copy of said opinion and judgment is appended to this petition in the Appendix at pp. A-1–A-11.

JURISDICTION

The opinion and judgment of the United States Court of Appeals for the Fifth Circuit was entered on November 5, 1970 (Appendix pp. A-1–A-11). Rehearing was denied on December 9, 1970 (Appendix p. A-12). The jurisdiction of this Court is invoked under 28 U.S.C.A., § 1254 (1) (Appendix p. A-13). Said statutory provision confers on this Court the jurisdiction to review the opinion and judgment of the United States Court of Appeals for the Fifth Circuit by writ of certiorari.

QUESTION PRESENTED

Whether, in a private civil action for a willful and intentional fraud based on Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, a plaintiff's contributory negligence or failure to exercise reasonable diligence to discover the fraud and protect itself therefrom will bar recovery?

STATUTE AND RULE INVOLVED

The statute and rule involved in this case are: Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C.A. § 78j, and Rule 10b-5, 17 C.F.R. § 240.10b-5, promulgated thereunder. Said statute and rule are set forth in the Appendix at pp. A-14–A-15.

STATEMENT OF THE CASE

This is an action brought under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder in which the petitioner sues for the sum of $308,133.95, plus interest, on account of an alleged continuing conspiracy by the respondents to defraud the petitioner.

The petitioner filed its Complaint in the United States District Court for the Northern District of Georgia, Atlanta Division, on December 6, 1963, the basis for Federal Jurisdiction being 15 U.S.C.A., § 78aa (Appendix p. A-16). The action came on for trial before the court and a jury, Hon. Albert J. Henderson, Jr., United States District Judge presiding, on May 5, 1969. At the conclusion of the trial on May 9, 1969, the jury having rendered its verdict, judgment was entered against the petitioner and in favor of all three respondents. From this judgment the petitioner appealed to the United States Court of Appeals for the Fifth Circuit on May 29, 1969. The decision of the Court of Appeals was rendered on November 5, 1970 (Appendix pp. A-1-A-10). Rehearing was denied on December 9, 1970 (Appendix p. A-12).

At all times material to the question presented, both the petitioner and respondent A. M. Kidder & Company, Inc. (hereinafter sometimes referred to as "Kidder & Co."), were engaged in the business of a stockbroker and respondent Edward M. Garrett (hereinafter sometimes referred to as "Garrett") was employed by and actively engaged in the business of Kidder & Co. as a registered representative of that firm. Respondent William J. McAlpin, Jr. (hereinafter sometimes referred to as "McAlpin") was a customer of both the petitioner and Kidder & Co.

The facts surrounding the fraud involved a complex scheme whereby the respondents created a false appearance of financial responsibility on the part of McAlpin so as to enable him to trade large volumes of securities with the petitioner. As noted in the decision rendered by the Fifth Circuit Court of Appeals, said facts are not in dispute.

In carrying out the conspiracy, Garrett advised McAlpin of various fraudulent schemes which enabled McAlpin to obtain large bank loans and trade large volumes of se-

curities with little or no capital, each of which schemes formed an integral part of and was executed pursuant to the overall conspiracy. Each of these fraudulent schemes, including its conception and execution, was admitted upon trial by McAlpin and, in many instances where McAlpin's testimony was corroborated by documentary evidence, by Garrett.

The evidence upon trial revealed the details of each transaction which was consummated by the respondents pursuant to the fraudulent schemes initially concocted by Garrett. While these details showed, without question, that the fraud perpetrated upon the petitioner by the respondents was willful and intentional, it is impossible to give a meaningful summary in brief form. The following examples, however, will serve to illustrate the deliberateness with which the fraud was perpetrated.

Prior to August 3, 1961, the date on which Magnavox stock was to split three-for-one, Garrett advised McAlpin of a means by which McAlpin could temporarily raise $20,000.00 with which to pay an outstanding debt. The operation of the scheme was to the effect that McAlpin would sell through the petitioner prior to August 3, 1961, 300 shares of old Magnavox stock; that, subsequent to said date, Garrett would purchase for McAlpin's account with Kidder & Co. 900 shares of the new Magnavox stock (the equivalent of 300 old shares); and that McAlpin would then deliver 300 shares of the new Magnavox stock to the petitioner and sell the remaining 600 shares through another stockbroker so as to have the use of the sales proceeds for several weeks.

This scheme was executed as planned and when the petitioner discovered that it was entitled to receive from McAlpin 600 additional shares of new Magnavox stock and inquired of their whereabouts, Garrett falsely stated that there had been a mistake in Kidder & Co.'s New

York office and continued to cover for McAlpin until he was able to make delivery of the 600 additional shares to the petitioner, said scheme furthering and adding to McAlpin's appearance of financial responsibility.

Another fraudulent scheme employed by the respondents involved the kiting of securities whereby McAlpin, in accordance with plans previously formulated by Garrett, sold through the petitioner securities which he did not then own. Pursuant to this scheme, Garrett delayed the petitioner and covered for McAlpin when the petitioner demanded delivery of said securities. Thereafter, Garrett purchased the securities for McAlpin and delivered same to him without receiving payment therefor in order to enable McAlpin to make delivery to the petitioner. This scheme enabled McAlpin to appear as the owner of said securities when in fact he was not. It also enabled Garrett and Kidder & Co. to receive additional commissions. A part of the loss ultimately sustained by the petitioner was due to the operation of this scheme in that, in winding up McAlpin's pending securities transactions, the petitioner was forced to purchase some $305,000.00 worth of securities for the purpose of making delivery against McAlpin's previous sales.

The remainder of the petitioner's loss was due to the termination of a check kiting operation conceived of by Garrett and executed by McAlpin which enabled McAlpin to trade securities with no capital to back up his purchases. Upon the termination of this operation, the petitioner was left holding five checks drawn by McAlpin, issued in payment of securities purchased, in the aggregate amount of $377,443.38.

The evidence upon trial also revealed that over a three to four month period prior to the issuance by McAlpin of the five checks referred to above, the petitioner had four of McAlpin's checks returned by the drawee bank

due to uncollected (as distinguished from insufficient) funds in his account. The evidence further revealed, however, that no part of the petitioner's loss was attributable to these checks in that each was made good by McAlpin who furnished to the petitioner a plausible reason as to why each such check had been returned.

Upon the conclusion of the trial, the court instructed the jury, in pertinent part, as follows:

> Now, the defendants also contend that the plaintiff did not exercise reasonable diligence to discover the existence of the alleged fraud. In that connection, I charge you that it is impossible to lay down any general rule as to the amount of evidence or number of evidential facts admitting discovery of fraud. But, facts in the sense of indisputable proof or any proof at all, are different from facts calculated to excite inquiry which impose a duty of reasonable diligence and which, if pursued, would disclose the fraud. Facts calculated to excite inquiry merely constitute objects of direct experience and, as such, may comprise rumors or vague charges if of sufficient substance to arouse suspicion. Thus, the duty of reasonable diligence is an obligation imposed by law solely under the peculiar circumstances of each case, including existence of a fiduciary relationship, concealment of the fraud, opportunity to detect it, position in the industry, sophistication and expertise in the financial community, and knowledge of related proceedings.
>
> If you find from the evidence in this case that the plaintiff had knowledge of facts sufficient to excite its inquiry, and that the peculiar circumstances of this case were sufficient to impose upon the plaintiff a duty of reasonable diligence, and that the plaintiff failed to exercise this duty, then you should return a verdict for the defendants.

After having deliberated for several hours, the jury returned and requested a recharge concerning reasonable diligence whereupon the trial court recharged the jury in the language above set forth over the repeated objection of the petitioner. Inquiry was then made by the jury as to whether it could apportion the petitioner's loss. To this inquiry, the court replied in the negative.

The jury then retired and, within less than 30 minutes thereafter, returned with a verdict in favor of all three of the respondents, including McAlpin who had admitted under oath that he had intentionally defrauded the petitioner out of some $308,000.00.

It is the above-quoted excerpt from the trial court's charge to which the petitioner objects and which constitutes the basis of the sole question presented for review.

REASONS FOR GRANTING WRIT OF CERTIORARI

There are compelling reasons why this Court should grant a writ of certiorari to review the opinion and judgment rendered by the Fifth Circuit Court of Appeals on November 5, 1970 (Appendix pp. A-1–A-11), affirming the judgment of the trial court entered on May 9, 1969.

First and foremost, the Court of Appeals has given the statute and rule here involved the narrowest possible construction whereby the rights of a plaintiff to recover thereunder are severely circumscribed. As thus construed, the rights of a plaintiff to recover for intentional fraud at common law in a great majority of jurisdictions are far superior to the rights of a plaintiff under the statute and rule.

Secondly, the Court of Appeals has decided an important issue of Federal law in a way that conflicts, directly or

in principle, with decisions rendered by this Court, other Courts of Appeal and other United States District Courts.

In addition, this case involves an important question of Federal law which has not been, but should be, settled by this Court. The question is vitally important in the administration of the securities laws enacted for the purpose of avoiding frauds and is a matter of grave importance to all persons for whose protection the statute and rule were adopted and who daily incur the risk of manipulative and deceptive devices in the trading of intricate merchandise.

Finally, the Court of Appeals has misapprehended and misapplied the principle of law enunciated in **City National Bank of Ft. Smith, Ark. v. Vanderboom**, 422 F. 2d 221 (8th Cir.), **cert. denied**, 399 U.S. 905, 90 S. Ct. 2196 (1970), in that it borrowed an unrelated "in connection with" test and imposed it as a condition to the right of a plaintiff to recover for intentional fraud contrary to the established common law rule in a majority of jurisdictions.

The reasons relied upon for the allowance of the writ of certiorari are amplified upon in the Argument which follows immediately hereafter.

ARGUMENT

I

The Court of Appeals, in Adopting a Minority Common Law View, Has Given the Statute and Rule the Narrowest Possible Construction Whereby the Rights of a Plaintiff to Recover Thereunder Are More Circumscribed Than Are the Rights of a Plaintiff to Recover for Intentional Fraud at Common Law in a Great Majority of Jurisdictions.

The holding of the court below adopts, in effect, the minority common law view of reliance as an element of actionable fraud, which view requires that the defrauded party allege and prove that he exercised reasonable care, or due diligence, in discovering the misrepresentation and protecting himself therefrom. While all jurisdictions require that there be reliance on a misrepresentation before it is actionable as fraud, the great majority does not allow **a lack of diligence** in discovering the misrepresentation to protect one guilty of **intentional** fraud. In support thereof, the various authorities cite some 35 jurisdictions (including England) which hold, directly or indirectly, that a defrauded party can recover for damages from willful fraud or misrepresentation without a showing of due diligence. See, 37 Am. Jur. 2d, **Fraud and Deceit**, § 250 (1968):

> In consideration of the effect of negligence of a representee on the right to rely, the policy of the law toward actual fraud must always be considered, since, under modern judicial concepts of social relationship, the actual wrongdoing of the representor is considered to outweigh the carelessness of the representee, at least in instances of actual machination and deception. It has frequently been stated or held that the doctrine of negligence does not authorize deception in what is

> said or unsaid, and hence, the effect of negligence on the part of the party deceived may be tolled by the active fraud of the other party. In other words, the rule sanctioned by most of the courts is that where one party to a transaction induces the other party to enter into it by wilful misrepresentation, he cannot escape liability for his fraud by showing that such party could have investigated the representations made and would then have found that they were untrue. According to this view, negligence in trusting a representation will not excuse a positive wilful fraud. . . . [Citations omitted.]

See, also, 37 C.J.S., **Fraud**, § 30(c) (1943); 1 Harper & James, Torts, § 7.12; Prosser, Torts, § 89, at 552 (2d ed. 1955).

In Georgia, where the minority view continues to prevail under the doctrine of stare decisis, the State Court of Appeals has openly expressed its dissatisfaction with the rule. See, **Lariscy v. Hill**, 117 Ga. App. 152, 153, 159 S.E.2d 433, 444 (1968), where the court stated:

> The allegations of the complaint present us with the problem of alleged fraud on the part of the defendants and lack of diligence on the part of the plaintiff. "The policy of the courts is on the one hand, to suppress fraud and, on the other, not to encourage negligence and inattention to one's own interests. The rule of law is one of policy. It is better to encourage negligence in the foolish, or fraud in the deceitful? Either course has obvious dangers." . . . The majority of jurisdictions hold that "judicial experience exemplifies that the former is less objectionable and hampers less the administration of pure justice." . . . Nevertheless, in Georgia a plaintiff cannot recover where he could have prevented the fraud by the exercise of ordinary care. . . . "In seeking to choose between

> a fraudfeasor and a negligent party, the Georgia law unfortunately goes with the alleged crook." . . . [Citations omitted.]

Perhaps the most cogent expression of the majority view is that found in **Judd v. Walker**, 215 Mo. 312, 114 S.W. 979 (1908), where Judge Lamm, after stating that the minority view would be "neither good ethics nor good law", concluded that:

> [U]ntil there be written into the law some precept or rule to the effect that the heart of man is as prone to wickedness as is the smoke to go upward and that every one must deal with his fellow man as if he was a thief and a robber, it ought not to be held that trust cannot be put in a positive assertion of a material fact, known to the speaker and unknown to the hearer, and intended to be relied on. [114 S.W. at 981.]

Upon considering that line of cases, cited *infra* at p. 15, wherein it is expressly stated that the statute and rule are not limited to circumstances which would give rise to a common law action for fraud and deceit, it is apparent that Congress has established its own standard which is to be measured by Federal law interpreting the Federal statute and rule unhindered by restrictive applications of state common law. This is necessary due to the need for uniform rules regulating transactions governed by Federal law. See **McClure v. Borne Chem. Co.**, 292 F. 2d 824, 833 (3rd Cir.), **cert. denied**, 368 U.S. 939, 82 S. Ct. 382 (1961).

The court below, however, has completely disregarded these and other cases hereinafter cited and, by its narrow construction of the statute and rule, has condoned, with no apologies or regrets, conduct by means of which one party to a securities transaction willfully, maliciously and with cunning design defrauded the other party out of some

$308,000.00, pocketed the fruits of his success and walked away leaving his victim with no recourse whatsoever—a situation which the statute and rule were intended to discourage and prevent.

II

The Court of Appeals, in Adopting a Restrictive Minority View, Has Decided an Important Issue of Federal Law in a Way That Conflicts, Directly or in Principle, With Decisions Rendered by This Court, Other Courts of Appeal and Other United States District Courts.

Neither the statute nor the rule involved in the case at bar attempts to define the type of fraud proscribed thereby. In fact, due to the absence of "fraud" language in subparagraph (b) of the rule, it has been said that fraud need not be implied in an action based thereon. See **Ellis v. Carter**, 291 F. 2d 270, 274 (9th Cir. 1961), where the court, in discussing the Securities Exchange Commission's authority to promulgate Rule 10b-5, stated:

> It would have been difficult to frame the authority to prescribe regulations in broader terms. Had Congress intended to limit this authority to regulations proscribing common-law fraud, it would probably have said so.

Thus, under the theory advanced by the Ninth Circuit Court of Appeals, to make out a case under the statute and rule the plaintiff must allege and prove only (a) use of the mails or instrumentalities of interstate commerce, (b) purchase or sale of a security, and (c) use of a manipulative or deceptive device. In other words, the Ninth Circuit, unlike the Fifth Circuit in the case at bar, has ruled that it is not necessary to allege or prove fraud in a cause of action based on subparagraph (b) of the rule whether it be of the common law variety or otherwise.

In reference to reliance as an element of actionable fraud, under which the plaintiff's diligence is a factor according to the minority common law view, the decision rendered by the court below is in direct conflict with **Kahan v. Rosenstiel**, 424 F. 2d 161 (3rd Cir.), **cert. denied**, 398 U.S. 950, 90 S. Ct. 1870 (1970). Here, the Third Circuit Court of Appeals recently held that proof of reliance is not an independent element which must be alleged to establish a cause of action under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. In reaching its decision, the Third Circuit noted that, in **Mills v. Electric Auto-Lite Co.**, 396 U.S. 375, 90 S. Ct. 616 (1970), this Court ruled that reliance on false or misleading proxy statements was not required in order to set forth a cause of action under Section 14(a) of the Securities Exchange Act, primarily because:

> Where the misstatement or omission in a proxy statement has been shown to be "material", as it was found to be here, that determination itself indubitably embodies a conclusion that the defect was of such a character that it might have been considered important by a reasonable shareholder who was in the process of deciding how to vote [*Id.* at 384, 90 S. Ct. at 621].

The Third Circuit also noted that a further reason for the **Mills** decision was that it would not be feasible to require proof of actual reliance by numerous persons and that reliance on the nondisclosure of a fact would be extremely difficult to define or prove. The Third Circuit thus reasoned that:

> Since Rule 10b-5 also prohibits only misrepresentations which are "material", the reasoning of the Supreme Court in **Mills** applies with equal force to suits brought for violation of that Rule. This is in accord with the view of the Second and Sixth Cir-

> cuits in Crane Co. v. Westinghouse Air Brake Co., 419 F. 2d at 797, and Britt v. Cyril Bath Co., 417 F. 2d at 436. [424 F. 2d at 174.]

It, thus, becomes apparent that the decision of the court below in the case at bar is in direct conflict with **Ellis v. Carter**, *supra*, decided by the Ninth Circuit, and **Kahan v. Rosenstiel**, *supra*, decided by the Third Circuit. And, in view of the reasoning employed by this Court in **Mills v. Electric Auto-Lite Co.**, *supra*, a conflict in principle is found to exist there.

The decision below also conflicts, in principle, with the views expressed by this Court in **SEC v. Capital Gains Research Bureau, Inc.**, 375 U.S. 180, 84 S. Ct. 275 (1963), where, in dealing with the meaning of clauses 1 and 3 of Section 206 of the Investment Advisers Act of 1940 [15 U.S.C.A., § 80b-6], the Court commented on the developing relaxations of the common law of fraud and concluded that, even if Congress intended to codify the common law, it did so "remedially" and not "technically".

> Congress intended the Investment Advisers Act of 1940 to be construed like other securities legislation "enacted for the purpose of avoiding frauds," not technically and restrictively, but flexibly to effectuate its remedial purposes. [*Id.* at 195, 84 S. Ct. at 284-85.]

Similar conclusions have been reached in cases expressly concerning Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. See, **Tcherepnin v. Knight**, 389 U.S. 332, 336, 88 S. Ct. 548, 553 (1967) ("[R]emedial legislation should be construed broadly to effectuate its purposes. The Securities Exchange Act quite clearly falls into the category of remedial legislation."); **SEC v. Gulf Intercontinental Fin. Corp.**, 223 F. Supp. 987, 995-96 (S.D. Fla. 1963) ("The

courts of this nation have consistently repeated that the acts shall be given a liberal construction to accomplish their purpose.").

The decision below, being expressive of the minority common law view, also conflicts, in principle, with another line of cases wherein the courts have repeatedly stated that the fraud provisions contained in the various securities laws are not limited to circumstances which would give rise to a common law action for fraud and deceit. See, *e. g.*, **Hooper v. Mountain States Sec. Corp.**, 282 F.2d 195 (5th Cir. 1960), **cert. denied**, 365 U.S. 814, 81 S. Ct. 695 (1961); **SEC v. Texas Gulf Sulphur Co.**, 258 F. Supp. 262 (S.D.N.Y. 1966), **modified**, 401 F.2d 833 (2d Cir. 1968), **cert. denied**, 394 U.S. 976, 89 S. Ct. 1454 (1969). While these cases were based on Section 10(b) and Rule 10b-5, the type of fraud proscribed by the statute and the rule was nowhere defined with specificity.

> The courts have traditionally refused, whether at common law deceit or under securities laws, to define fraud with specificity. Were any hard and fast rule to be laid down as to what constitutes fraud . . . "a certain class of gentlemen of the 'J. Rufus Wallingford' type—'they toil not neither do they spin'—would lie awake nights endeavoring to conceive some devious and shadowy way of evading the law." [III Loss, Securities Regulation 1436 (1961).]

Professor Loss does state, however, that, in reference to the several anti-fraud provisions and because of the legislative background, "it seems reasonable to assume at the very least that the most liberal common law views on these questions should govern under the statutes". III Loss, *op. cit. supra* at 1435.

Though the decision rendered by the Fifth Circuit in the case at bar does not speak in terms of "contributory negligence", its practical effect is to permit such an af-

firmative defense to be successfully asserted in a private cause of action arising under Section 10(b) and Rule 10b-5. When viewed in this manner, the decision below runs counter to the majority common law view which does not permit the negligence of the party wronged or defrauded to be interposed as a defense to a charge of positive, willful fraud.

> The general rule is that contributory negligence is not a defense to an action for fraud and deceit. Where fraud is the basis of the relief sought, the negligence of the defrauded party is not an answer. At any rate, to a charge of positive, wilful fraud, the negligence of the party wronged or defrauded may not be interposed as a defense . . . One who has perpetrated a fraud should not be permitted to say to the party defrauded when he demands relief that he ought not to have believed or trusted him and was negligent in doing so. [37 Am. Jur. 2d, **Fraud and Deceit**, § 384 (1968).]

See, also, cases cited in Prosser, Torts, § 103, at 731-32 (3rd ed. 1964).

Upon viewing the decision below as permitting contributory negligence to be asserted as a defense, such decision conflicts in principle, with **Johns Hopkins Univ. v. Hutton**, 297 F. Supp. 1165, 1221 (D. Md. 1968), **modified**, 422 F.2d 1124 (4th Cir. 1970), where the court expressly ruled that the defense of contributory negligence, not being available to a defendant at common law with regard to actions of deceit, was certainly not available to a defendant in a private cause of action based on Section 12(2) of the Securities Act of 1933 [15 U.S.C.A., § 77*l*(2)] for misrepresentations and omissions of material facts made by an employee of the defendant.

In view of the foregoing, the petitioner submits that the decision below conflicts not only with those cases concern-

ing the proper construction of the statute and rule but, also, with those cases having to do with affirmative common law defenses being asserted with respect to Federally created rights.

III

The Question Presented Is Vitally Important in the Administration of the Securities Laws Enacted for the Purpose of Avoiding Frauds.

Insofar as the petitioner has been able to determine, this is the first case in which any court has recognized contributory negligence as a defense to a private civil action for intentional fraud under Section 10(b) and Rule 10b-5. Defenses to such actions are generally matters of denying or disproving subject-matter jurisdiction, jurisdictional means and whatever elements turn out to be necessary in the trial court's interpretation. Bromberg, Securities Law: Fraud—SEC Rule 10b-5, § 11.5, at 253 (1969), and cases cited therein. The Fifth Circuit, however, has recently invoked broad common law barriers to relief in such actions. See, **Kuehnert v. Texstar Corp.**, 412 F.2d 700 (5th Cir. 1969), where, in 1969, the court permitted the defense of *in pari delicto*, and, of course, the case at bar where, in 1970, the same court permitted the defense of contributory negligence.

As a result of the decisions rendered by the Fifth Circuit Court of Appeals, the class of investors who may recover in a Rule 10b-5 action for damages has been severely restricted. This, it is most strongly submitted, frustrates severely the objective of the securities laws to increase the protection afforded the investing public and violates the injunction of this Court, as expressed in **SEC v. Capital Gains Research Bureau, Inc.**, 375 U.S. 180, 195, 84 S. Ct. 275, 284-85 (1963), that securities legislation enacted for the purpose of avoiding frauds is to be construed, not tech-

nically and restrictively, but rather flexibly to effectuate its remedial purposes.

Though application of the statute and rule was somewhat narrowed by the **Texstar** decision, such does not warrant the further erosion which will result if the decision below is permitted to stand. Viewed in light of the case at bar, the issue is clearly drawn: Will the objective of the securities laws be better promoted by protecting, at the expense of the negligent victim, the perpetrator of a successful and intentional fraud?

This Court has often indicated the inappropriateness of invoking broad common law barriers to relief where a private suit serves important public purposes. See, **e.g.**, **Perma Life Mufflers, Inc. v. International Parts Corp.**, 392 U.S. 134, 139, 88 S. Ct. 1981, 1984 (1968), where, in the field of antitrust law, this Court rejected the defense of *in pari delicto* and stated:

> [T]he purposes of the antitrust laws are best served by insuring that the private action will be an ever-present threat to deter anyone contemplating business behavior in violation of the antitrust laws. The plaintiff who reaps the reward of treble damages may be no less morally reprehensible than the defendant, but the law encourages his suit to further the overriding public policy in favor of competition. A more fastidious regard for the relative moral worth of the parties would only result in seriously undermining the usefulness of the private action as a bulwark of antitrust enforcement. And permitting the plaintiff to recover a windfall gain does not encourage continued violations by those in his position since they remain fully subject to civil and criminal penalties for their own illegal conduct.

Just as the private action in the field of antitrust law serves as a powerful deterrent, private actions under the

securities laws appear to be a major, and perhaps the most important, weapon in attainment of the policies exemplified by the statute and rule. As stated by Professor Bromberg: "private suits pursuant to the implied right of action are the biggest part of 10b-5's development and significance." Bromberg, Securities Law: Fraud—SEC Rule 10b-5, § 8.1, at 195 (1969). See, also, **J. I. Case Co. v. Borak**, 377 U.S. 426, 432, 84 S. Ct. 1555, 1560 (1964), where this Court, in dealing with proxy requirements under the securities laws, stated:

> Private enforcement of the proxy rules provides a necessary supplement to Commission action. As in antitrust treble damage litigation, the possibility of civil damages or injunctive relief serves as a most effective weapon in the enforcement of the proxy requirements.

Just as the *in pari delicto* defense was viewed as being a hindrance to the enforcement of the antitrust laws through the medium of "private attorneys general," **Perma Life Mufflers, Inc. v. International Parts Corp.**, *supra*, application of it and the contributory negligence defense as judicially imposed restraints on Rule 10b-5 litigation will hinder in similar fashion the effective weapon of the private suit in the securities field.

As stated in **Archer v. SEC**, 133 F. 2d 795, 803 (8th Cir.), **cert. denied**, 319 U.S. 767, 63 S. Ct. 1330 (1943), "the business of trading in securities is one in which opportunities for dishonesty are of constant recurrence and ever present." The impact of the decision rendered by the court below thus has no boundaries for, if permitted to stand, it will act as a haven for the deceitful whether they be brokers or customers.

We are not unmindful that, here, the announced principle of law is being applied at the expense of a securities broker. It must be assumed, however, that the courts of

this nation will dispense even handed justice by application of the same principle in future cases arising under the statute and rule where the injured party may, and probably will, be a broker's customer. Whether viewed in this light or in light of the case at bar, it is impossible to believe that the decision below will further the purposes for which the statute and rule were formulated.

IV

The Court of Appeals Has Misapprehended and Misapplied the Principle of Law Enunciated in City National Bank of Ft. Smith, Ark. v. Vanderboom, 422 F. 2d 221 (8th Cir.), cert. denied, 399 U.S. 905, 90 S. Ct. 2196 (1970).

An examination of the trial court's charge here complained of reveals that it was taken, practically verbatim, from **Tobacco & Allied Stocks, Inc. v. Transamerica Corp.**, 143 F. Supp. 323 (D.Del. 1956), **aff'd**, 244 F. 2d 902 (3rd Cir. 1957), a case which is totally inapplicable to the case at bar. While based on Section 10(b) of the Securities Exchange Act of 1934 and Rule 10-5 promulgated thereunder, **Transamerica** was not in any manner concerned with any obligation of the plaintiff to exercise reasonable diligence to discover the alleged fraud and protect itself therefrom. Instead, the case concerned itself with the date on which the plaintiff's cause of action accrued so as to determine whether suit was filed within the applicable period of limitations. The court eventually concluded that the plaintiff's cause of action accrued and the running of the applicable statute of limitations commenced at such time as the plaintiff could have discovered the alleged fraud by the exercise of reasonable diligence. *Id.* at 328-29.

The conclusion thus reached by the court in **Transamerica** is representative of the general rule as to when a cause of action based on fraud will accrue. See, 37 Am.

Jur. 2d, **Fraud and Deceit,** § 408 (1968). It is the contention of the petitioner, however, that the rule has no application to the case at bar inasmuch as the respondents have made no contention to the effect that the petitioner's cause of action was barred by any statute of limitations.

The error thus committed by the trial court in borrowing a principle of law totally unrelated to the case at bar and imposing it as a condition to the right of a plaintiff to recover for intentional fraud under Section 10(b) and Rule 10b-5 has been compounded by the Court of Appeals since the appellate court has sought to justify the ill-conceived charge by borrowing another unrelated principle of law from a totally different line of cases. Thus, should the decision below be permitted to stand, an important principle of law will have evolved by means of two distinct errors, each of which seeks to borrow from opposite directions a principle of law totally inapplicable to the question presented.

In attempting to justify the charge here complained of, the Fifth Circuit has undertaken to borrow the "in connection with" test set forth in **City National Bank of Ft. Smith, Ark. v. Vanderboom,** 422 F.2d 221 (8th Cir.), **cert. denied** 399 U.S. 905, 90 S. Ct. 2196 (1970), which test was fashioned for the purpose of determining whether the "in connection with" clause of Section 10(b) and Rule 10b-5 had been complied with.

The test, relied upon so heavily by the court below, appears to have evolved from **SEC v. Texas Gulf Sulphur Co.,** 401 F. 2d 833 (2d Cir. 1968), **cert. denied** 394 U.S. 976, 89 S. Ct. 1454 (1969), where the court broadly construed the "in connection with" clause in order to hold that proof of negligence was sufficient to sustain an action for injunctive relief under the statute and rule and stated that:

> Congress when it used the phrase "in connection with the purchase or sale of any security" intended only that the device employed, whatever it might be, be of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation's securities. [*Id.* at 860.]

The Second Circuit employed this test again in **Heit v. Weitzen**, 402 F. 2d 909 (2d Cir. 1968), **cert. denied** 395 U.S. 903, 89 S. Ct. 1740 (1969), in holding that the plaintiff had met the requirements of the "in connection with" clause.

Thereafter, the test was adopted and expanded upon by the Eighth Circuit in **Vanderboom** where the issue was whether the alleged fraud was "in connection with" the purchase or sale of any security since the party against whom recovery was sought did not sell or offer to sell any security of any kind to the aggrieved parties. In expanding upon the test earlier fashioned by the Second Circuit, the **Vanderboom** court stated its interpretation of the test as being in material part:

> With regard to misrepresentations, the question is whether a reasonable investor, in light of the facts existing at the time of the misrepresentation and **in the exercise of due care**, would have been entitled to rely upon the misrepresentation. With regard to nondisclosures, the issue becomes whether a reasonable investor, in light of the facts existing at the time of the nondisclosure and in the exercise of due care, would have been entitled to receive full disclosure from the party charged and would have acted differently had the alleged nondisclosure not occurred [422 F. 2d at 230. Emphasis added.]

It, thus, becomes apparent that the language added by the Eighth Circuit in stating its interpretation of the

test, *viz.*, "in the exercise of due care," not only has no relationship to the case at bar, but is utterly without precedent. Obviously, such language was not employed by the Second Circuit in either of the "in connection with" cases cited by the **Vanderboom** court in support of the test.

In none of these cases, cited with approval by the court below, was any attempt made to consider the proper construction of the statute and rule in reference to a private civil action for damages involving intentional fraud. Nor was any attempt made to determine what would constitute a valid legal defense to such an action. Instead, each of these cases involved a serious question as to whether the alleged fraud (concerning negligent misrepresentations only) was "in connection with" the purchase or sale of any securities due to the remoteness of the securities transactions in relation to the alleged fraud. In the case at bar, however, no such question is presented and none of the respondents have ever contended otherwise.

The petitioner submits that it would be patently absurd in the case at bar were it contended that the willful and intentional fraud perpetrated by the respondents was not "in connection with" the purchase or sale of securities. As a result, it is no less absurd to borrow the "in connection with" test and apply it as a condition to the right of a plaintiff to recover for intentional fraud contrary, as we have seen, to the established rule in a majority of jurisdictions.

CONCLUSION

It is respectfully submitted that this Court should not permit to stand the decision rendered by the court below which adopts a restrictive minority common law view so as to thwart the objectives of the statute and rule to

protect those who may become victims of intentional fraud in the conduct of securities transactions. For this and other reasons set forth hereinabove, it is respectfully submitted that this petition for a writ of certiorari should be granted.

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APPENDIX A

In the
United States Court of Appeals
For the Fifth Circuit

No. 28326

Clement A. Evans & Co., Inc.,
Plaintiff-Appellant,

versus

William J. McAlpine, Jr., et al.,
Defendants-Appellees.

Appeal from the United States District Court for the Northern District of Georgia

---

(November 5, 1970)

Before Bell, Simpson and Ingraham,
Circuit Judges.

Ingraham, Circuit Judge: This appeal arises from a civil action for damages brought by plaintiff/appellant, Clement A. Evans & Co., Inc., a stock brokerage firm [hereinafter referred to as Evans & Co.], against the defendants, William J. McAlpine, Jr., Edward M. Garrett and A. M. Kidder & Co., Inc., another stock brokerage firm [hereinafter referred to as Kidder & Co.].

Plaintiff's complaint alleged violation by the defendants of § 10(b) of the Securities Exchange Act of 1934, 15 U.S. C.A. §§ 78 et seq., 79j(b)[1] and Commission Rule 10B-5, C.F.R. § 240.10b-5 (1970),[2] promulgated thereunder.[3]

From a jury verdict and judgment for the defendants, the plaintiff appeals, urging as error the court's charge to the jury, failure to charge on a tendered instruction and an adverse evidential ruling.

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[1] § 78j(b) "Manipulative and deceptive devices.

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * * * *

"(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. * * *"

[2] § 240.10b-5 "Employment of manipulative and deceptive devices.

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

"(a) To employ any device, scheme, or artifice to defraud.

"(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

"(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

[3] The plaintiff's complaint did not allege, nor does it seek to recover under the common law remedy for fraud and deceit, which remedy was pursued separately in the state courts of Georgia. See A. M. Kidder & Co., Inc. v. Clement A. Evans & Co., Inc., 117 Ga.App. 346, 160 S.E. 2d 869 (1968).

The facts surrounding the alleged fraud, while not in dispute, involved a complex scheme whereby the defendants are purported to have created a facade of financial responsibility for the defendant McAlpine, thereby allowing him to trade a large volume of securities with the plaintiff Evans & Co., the net result being that Evans & Co. sustained a claimed loss of $308,133.95 due to five of McAlpine's checks, issued in payment for securities, being dishonored for insufficient funds.

While no useful purpose would be served in reviewing the details of each transaction which transpired, a succinct summary of the pertinent facts is appropriate for clearly delimiting the issues presented for appellate review.

McAlpine's dealings with Garrett, Kidder & Co. and Evans & Co. began in the spring of 1961. McAlpine, in order to expand his business interests and discharge his financial obligations, obtained banks loans upon the execution of personal trust receipts, which trust receipts were secured, in part, by securities pledged as collateral. A number of the securities so pledged were not then owned by McAlpine, and when the bank requested confirmation of McAlpine's ownership, McAlpine referred the bank to Garrett, the registered representative and agent for Kidder & Co., for verification. The evidence revealed that Garrett did verify McAlpine's ownership although McAlpine did not in fact own the securities. When the bank requested that the securities in question be liquidated and the proceeds therefrom be applied to reduce the loan balance in McAlpine's account, Garrett purchased the securities through Kidder & Co. with that company's funds and sold them the following day. The proceeds from that transaction were paid to the bank in favor of McAlpine's account. In order for McAlpine to reimburse Garrett and Kidder & Co. for the securities so purchased and applied to his account, he obtained additional bank

loans and again pledged as collateral securities which he did not own. In this manner, McAlpine was able to mirror an image of financial responsibility and solvency while the evidence indicates that the contrary was true.

Emboldened by his initial success, McAlpine began trading a significant volume of securities through the plaintiff, Evans & Co. The transactions, while complex to the neophyte investor, primarily took the form of daily "buy and sell" transactions. McAlpine would "sell" a particular security through Evans & Co.—a security which he did not own. By the time delivery was required of the stock so sold, McAlpine had obtained the stock through Kidder & Co. in negotiable form and merely gave in exchange therefor a signed receipt. When the stock was delivered to Evans & Co., McAlpine received a check representing the proceeds of the sale.

Concurrent with his sale of securities, McAlpine would consummate the "buy" portion of the transaction—purchasing securities from Evans & Co., and giving his personal check in payment therefor. The evidence upon trial revealed that over a three to four month period, McAlpine had checks to Evans & Co. dishonored for insufficient funds; yet despite this situation, which, in the terms of one of plaintiff's employees, was "explosive", Evans & Co. continued to transact business with McAlpine and accept his personal checks when normally such irregularities required the customer's trading account to be "frozen" for a period of 90 days.[4] It is the last five of McAlpine's checks which were returned to plaintiff for insufficient funds that comprise the $308,133.95 for which the plaintiff here seeks recovery.

Against this evidentiary backdrop the trial court instructed the jury in pertinent part as follows:

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[4] Federal Reserve Board Regulation T, 12 C.F.R. § 220.4(c)(8) (1970).

"Now, the defendants also contend that the plaintiff did not exercise reasonable diligence to discover the existence of the alleged fraud. In that connection, I charge you that it is impossible to lay down any general rule as to the amount of evidence or number or nature of evidential facts admitting discovery of fraud. But, facts in the sense of indisputable proof or any proof at all, are different from facts calculated to excite inquiry which impose a duty of reasonable diligence and which, if pursued, would disclose the fraud. Facts calculated to excite inquiry merely constitute objects of direct experience and, as such, may comprise rumors or vague charges if of sufficient substance to arouse suspicion. Thus, the duty of reasonable diligence is an obligation imposed by law solely under the peculiar circumstances of each case, including existence of a fiduciary relationship, concealment of the fraud, opportunity to detect it, position in the industry, sophistication and expertise in the financial community, and knowledge of related proceedings.

"If you find from the evidence in this case that the plaintiff had knowledge of facts sufficient to excite its inquiry, and that the peculiar circumstances of this case were sufficient to impose upon the plaintiff a duty of reasonable diligence, and that the plaintiff failed to exercise this duty, then you should return a verdict for the defendants."

It is the above quoted excerpt of the court's charge which the plaintiff objects to and which constitutes the focal point of our review.

Initially, plaintiff maintains that this private civil action for fraud based upon the Federal Securities Laws does not require application of the Georgia substantive law of fraud under the *Erie* doctrine as jurisdiction is not founded upon diversity of citizenship, but rather

arises under a federal statute. With this proposition we are quite in accord. However, we do not stamp with judicial imprimatur plaintiff's further assertion that reasonable diligence on its part is not a duty imposed by law in a 10b-5 civil action for damages. The predicate for this further proposition is that Georgia law requires a showing of "due diligence" on behalf of the plaintiff in protecting himself from fraud before civil liability will attach. Therefore, plaintiff argues, this not being a diversity case, due diligence is not a duty imposed upon plaintiff in the instant case. This argument, while cogent on its surface, lacks foundational support. Although the issue of due or reasonable diligence on the part of a private plaintiff in a civil action for fraud under § 10b-5 has not been frequently raised and, as a result, the precise issue is without precedent in this circuit; several decisions from other circuits have proved instructive.

Entering as we do a relatively unexplored area in the thicket of § 10b-5 litigation, we are mindful of the caveat sounded earlier by another panel of this Court that, "In this area especially, . . . a case-by-case approach is necessary to the proper development of controlling precedent." *Herpich v. Wallace,* ... F. 2d ... (5th Cir. 1970) [No. 27729, Slip. Op. p. 16, July 14, 1970]. Moreover, solutions in this area are not obtained by application of abstract rules, but rather must be formulated from the particular facts and circumstances of each case within the context of the principles and policy of the statute and the rule. See, e.g., *Kohler v. Kohler,* 319 F. 2d 634 (7th Cir. 1963).

Perhaps the most cogent analysis of the standards to be applied in both private damage actions and suits for injunctive relief under Rule 10b-5 is found in *City National Bank of Fort Smith, Ark. v. Vanderboom,* 422 F.2d 221 (8th Cir. 1970), *cert. denied,* 399 U.S. 905. The court in *Vanderboom* adopted and expanded upon a two-step test earlier fashioned by the Second Circuit in *Heit v. Weit-*

zen, 402 F.2d 909 (2nd Cir. 1968), *cert. denied,* 395 U.S. 903 (1969).

> "We think this two-step test breaks down as follows: (1) With regard to misrepresentations, the question is whether a reasonable investor, in light of the facts existing at the time of the misrepresentation *and in the exercise of due care,* would have been entitled to rely upon the misrepresentation. With regard to nondisclosures, the issue becomes whether a reasonable investor, in light of the facts existing at the time of the nondisclosure and in the exercise of due care, would have been entitled to receive full disclosure from the party charged and would have acted differently had the alleged nondisclosure not occurred. (2) If the plaintiff satisfies this 'in connection with' step, it then becomes necessary to determine whether the defendant's misrepresentation or nondisclosure was made with scienter or from a lack of due diligence. See *Texas Gulf Sulphur Co.,* 401 F.2d at 863."
>
> 422 F.2d at 230 (emphasis supplied).

In a footnote reference to the above quoted excerpt, the court quotes a commentator expressing the view that:

> "Not only should the plaintiff have to prove that he relied on the defendant's statements, but he must convince the trier of fact that his reliance was reasonable under all the circumstances at the time. In this way recovery would be denied to thc e who, because of their 'business sophistication,' acumen, or ready access to the information involved, could reasonably be expected to exercise a higher degree of care and investigation in their dealings."

And in reflecting upon that statement the *Vanderboom* court indicated that:

> "We feel that step one of our test properly reflects these considerations as the objective standard of a reasonable investor exercising due care in light of all facts effectively imposes a duty of reasonable investigation, thereby limiting the class of investors who will be protected under 10b-5(2) to conscientious buyers and sellers in good faith."
>
> 422 F.2d at 230, n.10.

We are in accord with the views expressed therein. While the commentator quoted by the court couched his language in the context of negligent misrepresentations, we are of the view that plaintiff's duty above espoused is not altered merely because the misrepresentations are alleged to be intentional rather than negligent. Surely plaintiff would not contend that a purchaser or seller could justifiably rely on a fraudulent misrepresentation, no matter how willfully and intentionally made, if that misrepresentation would tax even the most credulous mind.

We are cognizant, of course, that our views have a limiting effect upon the class of investors who may recover in a Rule 10b-5 action for damages. But such limitation is consistent with the views expressed in the decisions of this and other circuits.[5]

Thus, as the trial court instructed the jury in the instant case, the plaintiff's sophistication, expertise and business acumen in the financial community, his access to information and opportunity to detect the fraud are all relevant considerations in determining the exercise of reasonable diligence. *Kohler v. Kohler, supra,* at 641-642. See, also, *Rogen v. Ilikon Corp.,* 361 F.2d 260 (1st Cir. 1966); *Gerstle v. Gamble-Skogmo, Inc.,* 298 F.Supp. 66 (E.D.N.Y. 1969).

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[5] See *Herpich v. Wallace,* supra, at 22, n. 12 and cases cited therein.

The plaintiff further asserts that the portion of the lower court's charge here complained of is not in accordance with this court's views stated in *Hooper v. Mountain States Securities Corp.*, 282 F.2d 195 (1960). We do not agree. This court in *Hooper* rejected the defense of *in pari delicto* in a 10b-5 action as being without merit. Plaintiff's assertion that affirmative defenses, such as *in pari delicto* are thus not permitted in § 10b-5 actions, is without support as evidenced by this court's recent holding in *Kuehnert v. Texstar Corp.*, 412 F.2d 700 (1969), in which it was stated that *in pari delicto* is a defense available in a § 10b-5 action and the doctrine's application rests in the sound discretion of the trial court.

We have carefully examined the record in this case, and particularly the testimony relevant to the issue before us. That examination reveals that there was substantial evidence to support a jury finding of lack of reasonable diligence on the part of the plaintiff, and finding no error in the court's charge, that verdict is final. *Grumbles v. Times Herald Printing Co.*, 387 F.2d 593 (5th Cir. 1968), *cert. denied*, 390 U.S. 1028.

Inasmuch as the plaintiff's request to Charge No. 27 is the converse of that portion of the court's charge here under review, which we have found free from error, its rejection by the trial court did not constitute reversible error.

Turning to plaintiff's third and final point of error it is contended that the trial court improperly excluded from evidence a sworn statement by the defendant McAlpine consisting of some thirty-five pages and which chronicles the transactions participated in by the defendants.

We find no abuse of discretion in the trial court's exclusion of the tendered statement. It is conceded by the plaintiff that portions of the statement were inadmissible

as to the defendants Garret' and Kidder & Co., but claims that the remainder should have been admitted as an admission against interest of McAlpine, especially in view of the fact that plaintiff offered to mask the inadmissible portions from the jury's view.

Having again reviewed the record in detail, it is observed that counsel for the plaintiff conducted thorough and searching cross-examination of the defendant McAlpine eliciting from him the substance, and at times, verbatim, the contents of his sworn statement. Thus, while the subject matter may have been legally relevant, its logical relevance after cross-examination was justifiably suspect in that the detailed transactions in the statement were already before the jury. Moreover, McAlpine was furnished a copy of the statement during cross-examination and opposing counsel made frequent and extensive reference to it. We fail to observe any prejudice to the plaintiff from the trial court's ruling.

Accordingly, and in light of the foregoing, the judgment of the district court is AFFIRMED.

APPENDIX B

United States Court of Appeals
For the Fifth Circuit

October Term, 1969

No. 28326

D. C. Docket No. CA 8683
Clement A. Evans & Co., Inc.,
Plaintiff-Appellant
versus
William J. McAlpine, Jr. et al.,
Defendants-Appellees

Appeal from the United States District Court for the Northern District of Georgia

Before Bell, Simpson and Ingraham, Circuit Judges.

Judgment

This cause came on to be heard on the transcript of the record from the United States District Court for the Northern District of Georgia, and was argued by counsel;

On Consideration Whereof, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be, and the same is hereby, affirmed;

It is further ordered that plaintiff-appellant pay to defendants-appellees, the costs on appeal to be taxed by the Clerk of this Court.

November 5, 1970

Issued as Mandate;

APPENDIX C

In the
United States Court of Appeals
For the Fifth Circuit

No. 28326

Clement A. Evans & Co., Inc.,
Plaintiff-Appellant

versus

William J. McAlpine, Jr., et al.,
Defendants-Appellees

Appeal from the United States District Court for the Northern District of Georgia

---

(December 9, 1970)

On Petition for Rehearing

Before Bell, Simpson and Ingraham, Circuit Judges.
Per Curiam:

It Is Ordered that the petition for rehearing filed in the above entitled cause be and the same is hereby denied.

APPENDIX D

"28 U.S.C.A., § 1254. **Courts of appeals; certiorari; appeal; certified questions.** Cases in the courts of appeals may be reviewed by the Supreme Court by the following methods:

> (1) By writ of certiorari granted upon the petition of any party to any civil or criminal case, before or after rendition of judgment or decree; . . ."

APPENDIX E

"15 U.S.C.A., § 78j. **Manipulative and deceptive devices.** It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

. . .

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

APPENDIX F

"17 C.F.R., § 240.10b-5. **Employment of manipulative and deceptive devices.** It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud.

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security."

APPENDIX G

"15 U.S.C.A., § 78aa. **Jurisdiction of offenses and suits**

The district courts of the United States, and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder. Any criminal proceeding may be brought in the district wherein any act or transaction constituting the violation occurred. Any suit or action to enforce any liability or duty created by this chapter or rules and regulations thereunder, or to enjoin any violation of such chapter or rules and regulations, may be brought in any such district or in the district wherein the defendant is found or is an inhabitant or transacts business, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found. Judgments and decrees so rendered shall be subject to review as provided in sections 225 and 347 of Title 28. No costs shall be assessed for or against the Commission in any proceeding under this chapter brought by or against it in the Supreme Court or such other courts."

Supreme Court, U.S.
FILED
APR 20 1971
E. ROBERT SEAVER, CLERK

No. 1442

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1970

CLEMENT A. EVANS & COMPANY, INC.
Petitioner

v.

A. M. KIDDER & COMPANY, INC.,
EDWARD M. GARRETT and WILLIAM J. McALPIN, JR.,
Respondents

Brief on Behalf of Respondent A. M. Kidder & Company, Inc., in Opposition to the Petition for a Writ of Certiorari

To the United States Court of Appeals For the Fifth Circuit

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IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1970

No.

Clement A. Evans & Company, Inc.

Petitioner

v.

A. M. Kidder & Company, Inc.,
Edward M. Garrett and William J. McAlpin, Jr.

Respondents

Brief on Behalf of Respondent A. M. Kidder & Company, Inc., in Opposition to the Petition for a Writ of Certiorari

To the United States Court of Appeals For the Fifth Circuit

PART ONE

STATEMENT OF THE CASE

The statement of the case as set out by the petitioner treats as established fact all of the allegations in his petition. These, of course, were denied and the truth or falsity of these allegations, among other things, were the issues for the jury to pass on, together with the issue as to the use of reasonable care which is the principal matter before the court on this application.

PART TWO

ARGUMENT AND CITATION OF AUTHORITIES

The charge complained of given by the trial court was as follows:

> "Now the defendants also contend that the plaintiff did not exercise reasonable diligence to discover the existence of the alleged fraud. In that connection, I charge you that it is impossible to lay down any general rule as to the amount of evidence or number or nature of evidentual facts admitting discovery of fraud. But, facts in the sense of indisputable proof or any proof at all, are different from facts calculated to excite inquiry which impose a duty of reasonable diligence and which, if pursued, would disclose the fraud. Facts calculated to excite inquiry merely constitute objects of direct experience and, as such, may comprise rumors or vague charges if of sufficient substance to arouse suspicion. Thus, the duty of reasonable diligence is an obligation imposed by law solely under the peculiar circumstances of each case, including existence of a fiduciary relationship, concealment of the fraud, opportunity to detect it, position in the industry, sophistication and expertise in the financial community, and knowledge of related proceedings.
>
> "If you find from the evidence in this case that the plaintiff had knowledge of facts sufficient to excite its inquiry, and that the peculiar circumstances of this case were sufficient to impose upon the plaintiff a duty of reasonable diligence, and that the plaintiff failed to exercise this duty, then you should return a verdict for the defendants."

Petitioners concede that over a three or four month period immediately preceding the checks giving rise to the litigation that checks in substantial amounts had been returned by the bank. Surely, this was sufficient to give rise to the need of inquiry as to the validity of subsequent checks. In 37 C.J.S. Fraud, § 31, on page 276 it is stated:

> "It has been held, however, that one who is aware of suspicious circumstances or has learned of the falsity of one or more misrepresentations is under a legal duty to make a complete investigation and may not

> rely on the representations made; nor may he desist from further investigation because he is reassured of the truth of the original representations by the party suspected of fraud."

In U. S. v. Krueger, 228 Fed. 97, on page 103, it is stated:

> "Whatever is notice enough to excite attention and put the party on his guard and call for inquiry is notice of everything to which such inquiry might have led. When a person has sufficient information to lead him to a fact, he shall be deemed conversant of it. The presumption is that if the party affected by any fraudulent transaction or management might, with ordinary care and attention, have seasonably detected it, he seasonably had actual knowledge of it."

Petitioners concede that under the law of Georgia this rule prevails. They seek, however, to have the Court apply some other rule. The basis for this is unclear. In general, where a right is created by a federal statute and procedural and evidentuary matters are not spelled out, the District Court will apply the state law of the District in any proceedings thereunder. While this has not been decided with reference to the law of fraud under the Securities Act of 1934 (15 U.S.C.A. 78J (b)) it has been decided with reference to the applicable statute of limitations. In Turner v. Lundquist, 377 Fed. 2nd, 44 (Ninth Circuit 1967), it is stated:

> "Since there is no federal statute of limitations applicable to 15 U.S.C.A. § 78b and 15 U.S.C. § 77q, California's three-year statute (California Code of Civil Procedure, Section 338 (4) is applicable. Errion v. Connell, (9th Cir. 1956), 236 F. 2d 447. . . . Because the alleged fraud occurred in California, and the California statute of limitations applies in this case, we must look to California law to determine when the statute begins to run so as to bar this action."

This same conclusion was reached in Janigan v. Taylor, 344 F. 2d, 781, (First Circuit), and in Dack et al. v. Shanman et al., 227 Fed. Supp. 26, and Osborne v. Mallory, 86 Fed. Supp. 869.

In Sackett v. Beaman, 399 Fed. 2d, 884, 1968, on page 890, it is stated:

> "In such cases, where the action is one at law, such as Sackett proposed in his second amended complaint, it is federal policy to adopt the local law of limitation."

In addition, a standard of conduct is clearly established in Regulation T of the Board of Governors of the Federal Reserve System. Among other provisions of that Regulation is the requirement that a stock broker cease doing business with a customer where, for any reason, a security has been delivered and payment therefor has not been received. In the case of a check, this means that the check itself must have cleared. Under the uncontradicted testimony by an officer of the petitioner, less than thirty days before these particular checks were returned, a check in the amount of $28,725.00 had been returned. Had the petitioner complied with the provisions of Regulation T and "frozen" McAlpin's account for the required ninety day period, these transactions could not have occurred. While this regulation is mandatory it clearly establishes a standard of care which should have governed the petitioner.

CONCLUSION

From the foregoing, it appears clear that the judgment of the Court of Appeals is correct and that the petition for a writ of certiorari should be denied.

Respectfully submitted,

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SUPREME COURT, U. S. FILED
JUN 21 1971
E. ROBERT SEAVER, CLERK

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1970

No. 1442

CLEMENT A. EVANS & COMPANY, INC.,
Petitioner,

vs.

A. M. KIDDER & COMPANY, INC., EDWARD M. GARRETT and WILLIAM J. McALPIN, JR.,
Respondents.

PETITION FOR REHEARING OF ORDER DENYING PETITION FOR WRIT OF CERTIORARI

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St. Louis Law Printing Co., Inc., 411-15 N. Eighth St. 63101 314-231-4477

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PETITION FOR REHEARING OF ORDER DENYING PETITION FOR WRIT OF CERTIORARI

Petitioner, Clement A. Evans & Company, Inc., prays that this Court grant rehearing of its order of May 17, 1971, denying the petition for writ of certiorari and that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fifth Circuit in the above-entitled case as prayed for in the petition filed March 5, 1971, herein.

REASONS FOR GRANTING REHEARING AND ISSUING THE WRIT

1. At least three recent Federal Court decisions have had occasion to wrestle with the issue of the type of reliance, if any, required to sustain a private civil action for damages based on Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. It is precisely this issue which forms the basis of the sole question presented herein, *viz.*, whether, in a private civil action for a willful and intentional fraud based on the statute and the Rule, a plaintiff's contributory negligence or failure to exercise reasonable diligence to discover the fraud and protect itself therefrom will bar recovery?

The holding of the Court below not only requires *some* reliance, as most of the authorities seem to require and as stated in *Baumel v. Rosen,* 283 F. Supp. 128, 140 (D. Md. 1968), *aff'd in part, rev'd in part,* 412 F. 2d 571 (4th Cir. 1969), *cert. denied,* 396 U. S. 1037, 90 S. Ct. 681 (1970), but, rather, the restrictive minority common law view of reliance which includes, as a part thereof, the further requirement that the defrauded party must allege and prove that he exercised reasonable care, or due diligence, in discovering the misrepresentation and protecting himself therefrom.

The first of these recent decisions is that of *Chasins v. Smith, Barney & Co.,* CCH Fed. Sec. L. Rep. ¶ 92,962 at p. 90,555 (2d Cir. March 2, 1971), a case decided only three days prior to the date on which the petitioner filed its petition for writ of certiorari. There, the court equated "adequate reliance" with "causation in fact" and noted the existing state of confusion concerning the reliance requirement by using such language as: "To the extent that reliance is necessary for a finding of a 10b-5 viola-

tion. . . ." *Id.* at 90,559. It is significant to note that, while there was no evidence of intentional fraud in *Chasins,* the case was decided by the United States Court of Appeals for the Second Circuit, the same court which first formulated the unrelated "in connection with" test which, as discussed in detail in the petition for writ of certiorari, was borrowed by the court below and erroneously relied upon in rendering the decision here complained of.

Another of these recent decisions is *Johns Hopkins Univ. v. Hutton,* CCH Fed. Sec. L. Rep. ¶ 93,033 at p. 90,824 (D. Md. April 12, 1971), in which the subject of reliance, as related to private civil actions arising under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, was discussed in considerable detail though not decided. There, as in the case at bar, the victim of the fraud contended that *Mills v. Electric Auto-Lite Co.,* 396 U.S. 375, 90 S. Ct. 616 (1970), and *Kahan v. Rosenstiel,* 424 F. 2d 161 (3rd Cir.), *cert. denied,* 398 U.S. 950, 90 S. Ct. 1870 (1970), dispensed with the requirement of reliance in cases such as those arising under the statute and the Rule. Although the court neither accepted nor rejected this contention (it concluded that the plaintiff had, in fact, relied upon the misrepresentations and omissions of the defendant's agent), it noted that the misrepresentations and omissions were not obvious to "even the most credulous mind" and cited, in support of the quoted language, the decision rendered by the Fifth Circuit in the case at bar.

The language thus quoted does, of course, appear in the decision below where the court opined, without any citation of authority, that one should not recover on account of a "fraudulent misrepresentation, no matter how willfully and intentionally made, if that misrepresentation would tax even the most credulous mind." Appendix to

Petition for Writ of Certiorari p. A-8. In making such a statement, however, it appears that the court below was concerned not with the facts in the case at bar but with where the line may properly be drawn in an extreme hypothetical situation in which the fraudulent misrepresentation must, of necessity, be obvious to the recipient. In this respect, the petitioner suggests that, where misrepresentations are willfully and intentionally made, a plaintiff should be entitled to recover unless the truth is apparent to his observation or discoverable without effort so as to be substantially equivalent to actual knowledge of the truth. This, in effect, is the rule stated by Professor Prosser in his treatise on torts:

> Contributory negligence is properly a defense to an action based on a representation which is merely negligent; but where it is intended to mislead, the recipient is not required to investigate, and his reliance is regarded as unjustified only if the truth should be apparent to his observation, or discoverable without effort. [*Prosser, Torts* § 89 at 550. (2d ed. 1955.)]

In any event, the test suggested by the Fifth Circuit, which would deny recovery if the misrepresentation were such as would tax even the most credulous mind, is far removed from the instruction under which the case at bar was submitted to the jury and upon which the jury rendered its verdict. If permitted to stand, the decision below may well become the forerunner of a test of reliance in cases based on Section 10(b) and Rule 10b-5 notwithstanding the fact that it is by no means certain that reliance is a requirement in such cases. See, *e.g., Johns Hopkins Univ. v. Hutton, supra,* at 90,829, where the confusion of the court becomes apparent in its use of the words "Even if that 'right to rely' requirement exists in this case. . . ."

Another recent decision which tends to further cloud the issue is that of *Mitchell v. Texas Gulf Sulphur Co.*, CCH Fed. Sec. L. Rep. ¶ 93,019 at p. 90,752 (10th Cir. April 26, 1971), in which reliance was required and was found to exist in an action based on the statute and the Rule. Total recovery was denied, however, due to the widespread publication of a curative statement which, in the court's opinion, terminated the plaintiff's right to rely on the previous misrepresentation. The court thus imposed the requirement that "stockholders too act in good faith and with due diligence in purchasing and selling stock". *Id.* at 90,761.

In view of the foregoing statement, the *Mitchell* case must align itself with the case at bar for the purpose of further demonstrating a conflict among the circuits. It was noted, however, that, while in some circumstances the lack of due diligence may not be unreasonable, "under the circumstances of this case it would injustifiably extend . . . [the defendant's] liability to intolerable limits". *Id.* at 90,761. A brief comparison of the "circumstances" there involved with those present in the case at bar reveals no similarity whatsoever and, it is respectfully submitted, to deny recovery to the petitioner under the present circumstances would unjustifiably *restrict* the respondents' liability to "intolerable limits". In this respect, it must be remembered that the court below, in adopting a minority common law view of reliance, has given the statute and Rule the narrowest possible construction whereby the rights of a plaintiff to recover thereunder are more circumscribed than are the rights of a plaintiff to recover for intentional fraud at common law in a great majority of jurisdictions. As thus construed, the court below has condoned conduct by means of which one party to a securities transaction willfully, maliciously and with cunning design defrauded the other party out of some $308,000.00, pocketed the fruits of his success and walked

away leaving his victim with no recourse whatsoever, a situation which the statute and Rule were intended to discourage and prevent.

2. With each passing day, the decision below, which recognizes contributory negligence as a defense to a private civil action for intentional fraud under Section 10(b) and Rule 10b-5, becomes more important in the administration of the securities laws enacted for the purpose of avoiding frauds. At a time when the bench, bar and other concerned citizens are striving for a return to respect for law and order, the decision here complained of and which should be reviewed by this Court cannot help but lead one to believe that crime does pay and, in cases such as this, very handsomely. As stated in *Bishop v. E. A. Strout Realty Agency,* 182 F.2d 503, 505 (4th Cir. 1950), a case of common law deceit:

> There is nothing in law or in reason which requires one to deal as though dealing with a liar or a scoundrel, or that denies the protection of the law to the trustful who have been victimized by fraud. The principle underlying the caveat emptor rule was more highly regarded in former times than it is today; but *it was never any credit to the law to allow one who had defrauded another to defend on the ground that his own word should not have been believed.* [Emphasis added.]

In addition, the importance of the sole question presented should be even more apparent in view of the number of recent conflicting decisions on the subject and others which may reasonably be expected to follow.

CONCLUSION

It is respectfully submitted that this Court should review the decision rendered by the court below and resolve, once and for all, the confusion and conflicts which exist in, between, and among the various courts of this land as noted herein and in the petition for writ of certiorari. For this and other reasons set forth hereinabove and in the petition for writ of certiorari, it is respectfully urged that rehearing be granted and that, upon such rehearing, a writ of certiorari issue to the United States Court of Appeals for the Fifth Circuit.

Respectfully submitted

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I hereby certify that the foregoing Petition for Rehearing is presented in good faith and not for delay and is restricted to grounds specified in Rule 58 of the Rules of this Court.

J. Clifton Barlow, Jr.